Nos. 12959, 12970, 12971

# In the United States Court of Appeals for the Ninth Circuit

C. Abbott Lindsey and Pauline Lindsey, *Petitioners*

v.

Commissioner of Internal Revenue, *Respondent*

Commissioner of Internal Revenue, *Petitioner*

v.

Eleanore Langer, *Respondent*

Commissioner of Internal Revenue, *Petitioner*

v.

Estate of R. L. Langer, Deceased;
Eleanor Langer, Executrix, *Respondent*

**On Petitions for Review of the Decisions of the Tax Court of the United States**

## BRIEF FOR THE COMMISSIONER OF INTERNAL REVENUE


Theron Lamar Caudle,
*Assistant Attorney General.*

Ellis N. Slack,
A. F. Prescott,

Edward J. P. Zimmerman,
*Special Assistants to the Attorney General.*



FILED
OCT 10 1951

# INDEX

Page

Previous opinions ........ 1

Jurisdiction ........ 2

Questions presented ........ 3

Statute and Regulations involved ........ 4

Statement ........ 4

Statement of points to be urged by the Commissioner ........ 7

Summary of argument ........ 7

Argument:

The Tax Court properly defined gross income in the case of the Lindseys as gross receipts less the cost of goods sold, but erroneously failed to apply this concept to the Langers ........ 9

Conclusion ........ 21

Appendix ........ 22

## CITATIONS

Cases:

*Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179 ........ 10
*Snyder* v. *Commissioner*, 295 U. S. 134 ........ 11
*Southern Pacific Co.* v. *Lowe*, 247 U. S. 330 ........ 10
*Woodside Acres* v. *Commissioner*, 134 F. 2d 793 ........ 12

Statutes:

Individual Income Tax Act of 1944, c. 210, 58 Stat. 231:
Sec. 2 ........ 14
Sec. 8 (26 U.S.C. 1946 ed., Secs. 22, 23, 117) ........ 14, 15
Sec. 9 (26 U.S.C. 1946 ed., Sec. 23) ........ 15
Sec. 10 (26 U.S.C. 1946 ed., Sec. 251) ........ 15
Sec. 13 (26 U.S.C. 1946 ed., Sec. 60) ........ 15

Internal Revenue Code:
Sec. 22 (26 U.S.C. 1946 ed., Sec. 22) ........ 10, 19
Sec. 23 (26 U.S.C. 1946 ed., Sec. 23) ........ 15, 16
Sec. 60 (26 U.S.C. 1946 ed., Sec. 60) ........ 15
Sec. 107 (26 U.S.C. 1946 ed., Sec. 107) ........ 3, 5, 6, 7, 9, 10, 13, 14, 16, 22, 23, 24, 26
Sec. 117 (26 U.S.C. 1946 ed., Sec. 117) ........ 15
Sec. 251 (26 U.S.C. 1946 ed., Sec. 251) ........ 15, 17, 18

MISCELLANEOUS: Page

Holmes, Federal Income Tax (Sixth ed.) 501 ____ 11
H. Rep. No. 1365, 78th Cong., 2d Sess., p. 24 (1944 Cum. Bull. 821, 838) ____ 14
I. T. 1241, I-1 Cum. Bull. 234 (1922) ____ 11
I. T. 3981, 1942-2 Cum. Bull. 78 ____ 17
III Kester, Accounting Theory and Practice (1921 ed.), p. 514__13, 20
Larsen, Milk Production Cost Accounts, pp. 2-3, 24-26, 38-45 ____ 12
Mim. 2915, I-1 Cum. Bull. 233 (1922) ____ 11
Treasury Regulations 111:
Sec. 29.22(a)-5 ____ 11
Sec. 29.107-3 ____ 23

Nos. 12959, 12970, 12971

# In the United States Court of Appeals for the Ninth Circuit

---

C. Abbott Lindsey and Pauline Lindsey, *Petitioners*

v.

Commissioner of Internal Revenue, *Respondent*

---

Commissioner of Internal Revenue, *Petitioner*

v.

Eleanore Langer, *Respondent*

---

Commissioner of Internal Revenue, *Petitioner*

v.

Estate of R. L. Langer, Deceased;
Eleanor Langer, Executrix, *Respondent*

---

**On Petitions for Review of the Decisions of the Tax Court of the United States**

---

## BRIEF FOR THE COMMISSIONER OF INTERNAL REVENUE

---

### PREVIOUS OPINIONS

The original opinion of the Tax Court (R. 85-97, No. 12456) is reported at 13 T. C. 419. The opinion of this Court on appeal from the decisions therein is reported

at 183 F. 2d 758. The opinion of the Tax Court on remand (R. 15-29, No. 12970)[1] is reported at 16 T. C. 41.

JURISDICTION

These petitions for review (R. 66-68, No. 12959; R. 31-32, Nos. 12970, 12971) involve federal income taxes for the years 1944 and 1945. On September 24, 1947, and February 19, 1948, the Commissioner of Internal Revenue mailed to taxpayers notices of deficiency in the total amount of $16,002.32. (R. 6-9, 16-19, 26-31, 50-55, No. 12456.) Within ninety days, respectively, thereafter and on December 17, 1947, and May 11, 1948, taxpayers filed petitions with the Tax Court for redeterminaton of the particular deficiency asserted against each under the provisions of Section 272 of the Internal Revenue Code. (R. 2-9, 11-19, 20-31, 44-55, No. 12456.)[2] The decisions of the Tax Court affirming the Commissioner's determination of deficiency were entered September 29, 1949. (R. 98, 99, 100, 101, No. 12,456.) These cases were brought to this Court by a petition for review filed December 6, 1949 (R. 102-107, No. 12456), pursuant to the provisions of Section

---

[1] To avoid confusion, when references are made in this brief to the opinion of the Tax Court on remand, we shall refer to the record in Docket No. 12970. Although we moved this Court for consolida-tion of the cases herein, in order to avoid unnecessary duplication, inadvertantly the opinion of the Tax Court was printed three times, in each of the volumes of printed record herein.

[2] Page 55 of the printed record in Docket No. 12456 reads that one of the petitions for a redetermination of deficiency was filed May 11, 1949. A check of the docket entries in the Tax Court reveals that this is a typographical error, the correct date of filing being May 11, 1948.

1141(a) of the Internal Revenue Code, as amended by Section 36 of the Act of June 25, 1948.

On appeal this Court remanded to the Tax Court. On remand the Tax Court on April 3, 1951, entered decisions of deficiency in income tax with respect to the Lindseys (R. 64, 65, No. 12959) and of overpayment of income tax with respect to the Langers (R. 30, Nos. 12970, 12971). The cases are brought to this Court for a second time by petitioners for review filed May 2, 1951 (R. 66-68, No. 12959), and May 3, 1951 (R. 31-32, Nos. 12970, 12971), pursuant to the provisions of Section 36 of the Act of June 25, 1948. Although three separate petitions for review were filed, this Court subsequently consolidated the cases on motion of the Commissioner of Internal Revenue.

## QUESTIONS PRESENTED

Whether back pay received by taxpayers in 1944 and 1945 exceeded 15% of their gross income for those years as that term is used in Section 107(d) of the Internal Revenue Code. This in turn depends upon:

1. Whether, in the case of the Lindseys, their gross income from the Commodore Cafe operated as a sole proprietorship, is to be computed by subtracting only the cost of goods sold from gross receipts, or whether other business deductions should also be made; and

2. Whether, in the case of the Langers, who operated properties as joint ventures, their shares of the gross income of the ventures should be considered a part of their gross income or whether they should include in gross income only their net distributive shares from the venture.

## STATUTE AND REGULATIONS INVOLVED

The pertinent statute and Regulations may be found in the Appendix, *infra.*

## STATEMENT

The facts, as found by the Tax Court in the original proceedings (R. 87-93, No. 12456) and as relevant on these petitions for review, may be summarized as follows:

R. L. Langer, now deceased, and C. Abbott Lindsey were, during the taxable years involved, officers and employees of Commodore Hotel Company, Ltd., a California corporation. Although they claimed to be entitled to certain sums by way of salary—$600 per month—neither received any salary during the years from 1938 through 1942. In each of those years, through 1941, Commodore showed operating losses, its balance sheets showing continuing deficits. Throughout the period, the corporation's hotel building, fixtures, and furnishings were subject to a deed of trust and chattel mortgage securing a promissory note payable to Pacific Mutual Life Insurance Company on which Commodore was chronically in default. Commodore realized in 1942 for the first time for a number of years operating profits after making the required installment payments to Pacific. As a result, in 1943 it became able to resume salary payments to Langer and Lindsey. In January, 1944, moreover, the board of directors ordered payment of the accrued back salaries as rapidly as the corporation's financial condition would warrant. Pursuant to this action, Langer and Lindsey each received, in addi-

tion to current salaries, $10,000 in 1944, and Lindsey $11,500 in 1945. (R. 88-91, No. 12456.)

In their tax returns for 1944 Langer and wife and Lindsey and wife each reported $5,000 as his or her community share of the back payments and computed the tax thereon at the rates applicable to the years for which the salary was paid, claiming the benefits of Section 107(d) of the Internal Revenue Code. Lindsey and wife proceeded similarly with respect to the year 1945. The Commissioner, however, holding that Section 107(d) was not applicable, determined tax deficiencies for the years 1944 and 1945. (R. 91-93, No. 12456.) The Tax Court sustained the Commissioner, holding that Commodore's failure to pay Langer and Lindsey their authorized salaries in the years 1938 through 1942 was the consequence of a restraint voluntarily imposed upon itself, and not the result of a legally enforceable external restriction such as the court thought essential to bring the case within the orbit of Section 107(d). (R. 93-97, No. 12456.) This holding the Court of Appeals for the Ninth Circuit reversed, considering the requirements of the statute satisfied, and remanded to the Tax Court to dispose of issues which that court had not reached.

On remand, the Tax Court determined (R. 15-29, No. 12970), in taxpayer's favor, that the back pay received by Langer and Lindsey was paid pursuant to prior agreement and legal obligation. With respect to the Lindseys, the Tax Court determined that the back pay was less than 15% of gross income, and that they were therefore not entitled to the benefit of Section 107(d). With respect to the Langers, however, the Court deter-

mined that the back pay was in excess of 15% of gross income, and the benefits of Section 107(d) were therefore available to them. The Lindseys appealed to the Ninth Circuit; the Commissioner filed petitions for review in the Langer cases.

The Tax Court found additional facts on remand. As important herein, they are (R. 22-23, No. 12970):

> The Clifton Hotel was operated as a joint venture in 1944 by the Langers in conjunction with Nelda Clinton and Mary R. Brown. The Figueroa Hotel was operated as a joint venture in 1944 by the Langers in conjunction with Clifford Clinton and R. M. Callicott. The Langers' distributive share of the net profits in that year from such joint ventures was $7,249, or $3,624.50 apiece, from the Clifton Hotel, and $31,220.71, or $15,610.35 apiece, from the Figueroa Hotel.
>
> The back pay of $10,000 received by R. L. Langer in 1944 from the Commodore Hotel Company, allocable $5,000 to R. L. Langer and $5,000 to Eleanore Langer, comprised more than 15 per cent of their respective gross incomes of $30,729.45 and $31,854.43.
>
> The gross income reported by the Lindseys in 1944 was $44,183.52, or $22,091.76 apiece. Their gross income for 1944 was actually $101,569.40 or $50,784.70 apiece, computed to include "other business deductions" of the Commodore Cafe, amounting to $57,385.88. The back pay of $10,000 received by C. Abbott Lindsey in 1944 from the Commodore Hotel Company, allocable $5,000 to Lindsey and $5,000 to Pauline Lindsey, comprised less than 15 per cent of such gross incomes.
>
> In 1945 the total receipts of the Commodore Cafe, as reported by the Lindseys, were $144,897.95,

cost of goods sold $58,911.83, other business deductions $65,564.72. The gross income reported by the Lindseys in 1945 was $52,493.82, or $26,246.91 apiece. Their gross income for 1945 was actually $118,058.54, or $59,029.27 apiece, computed to include "other business deductions" of the Commodore Cafe, amounting to $65,564.72. The back pay of $11,500 received by C. Abbott Lindsey in 1945 from the Commodore Hotel Company, allocable $5,750 to Lindsey and $5,750 to Pauline Lindsey, comprised less than 15 per cent of such gross income.

## STATEMENT OF POINTS TO BE URGED BY THE COMMISSIONER

The Tax Court erred in holding that the "back pay" received by the Langers in 1944 exceeded 15% of their gross income in that year. Accordingly, the Tax Court erred in its determination that each of the Langers had overpaid his income taxes for that year.

## SUMMARY OF ARGUMENT

The sole issue herein is what constitutes gross income under Section 170(d) of the Internal Revenue Code. Gross income ordinarily connotes something different from gross receipts, for it more nearly connotes gain than gain plus return of capital. Accordingly, the authorities define business gross income as gross receipts less the cost of goods sold, the cost of goods sold properly being considered the return of direct outlay of capital. This concept of gross income has stood unchallenged for many years, and the Tax Court's treatment of the Lindseys' gross income is consistent with it.

On their returns for the years 1944 and 1945 the Lindseys deducted from gross receipts the cost of the

goods sold in their restaurant business to arrive at gross profit. Further following good accounting practice, they deducted indirect operating expenses from gross profit to arrive at net profit. But they erroneously argue that only the net profit should be included in their individual gross income. It is clear from the authorities that for purposes of their business and their individual returns, gross income is synonymous with gross profit.

Taxpayers' argument that individual gross income is the sum of income items appearing on page one of the individual tax returns for the years 1944 and 1945 is erroneous. This sum is, instead, denominated by the Internal Revenue Code as adjusted gross income. It is clear not only from the words used but from other sections of the Code that adjusted gross income is something different from both net income and gross income. In fact the Code defines adjusted gross income as something considerably less than gross income. It is also something more than net income.

We believe the Tax Court erred in holding that because the Langers were joint ventures they need only include in their individual gross income their distributive shares of the net income of the joint ventures. Instead they should include their shares of the venture gross income in their individual gross income. This position is supported by prior rulings of the Bureau of Internal Revenue. We contend that both the Langers and Lindseys should report a similar gross income; the forms of their doing business, in the ascertainment of gross income, do not in the instant case make any difference. The distinction between their forms of

doing business is not like that between doing business as an individual or receiving income by way of corporate dividends. In ascertaining net income from their joint ventures, the Langers deducted all the expenses of operation. It is clear from the items deducted that while they are deductible from gross receipts to arrive at net income, many, if not most, of them are not deductible from gross receipts in order to ascertain gross income, for many of the deducted items are indirect costs of operation or overhead. It would take but a small sum to increase the Langers gross income to a point beyond that which bars to them the benefits of Section 107(d), and their returns for the year 1944 indicate more than enough that should have been added to gross income to increase their individual gross income to that extent.

## ARGUMENT

### The Tax Court Properly Defines Gross Income in the Case of the Lindseys as Gross Receipts Less the Cost of Goods Sold, but Erroneously Failed to Apply this Concept to the Langers

There is no dispute with respect to the facts herein. The issue before the Court calls for a determination of what constitutes gross income within the meaning of Section 107(d) of the Internal Revenue Code (Appendix, *infra*). That section provides that if an individual receives back pay in excess of 15% of his gross income for the year of receipt, he is entitled to the benefits of the section, provided certain other conditions, all met herein, are satisfied.

Taxpayers argue that the Lindseys should be entitled to deduct from gross receipts of their Commodore Cafe business not only the cost of goods sold, but also other

business deductions. In other words, taxpayers argue that only net profits of the business, rather than gross profits, should be included in individual gross income. It is our position, however, that the Tax Court properly included gross profit in gross income.

With respect to the Langers, we disagree with the Tax Court's determination that only their net distributive share of the joint ventures in which they were engaged should be included in gross income. Similarly as we contend in the Lindsey cases, we contend that the Langers' distributive share of the gross profit of the joint venture should be included in their gross income, not just the net profit.

Initially, before undertaking a discussion of the method of reporting income chosen by the Lindseys and the Langers, we must determine what gross income is within the meaning of Section 107(d). Logically, and the provisions of Section 22(a) of the Code defining gross income as gains, profits, and income from various sources and any source whatever lend the logic further support, gross income ordinarily connotes something different from gross receipts. *Southern Pacific Co.* v. *Lowe,* 247 U. S. 330, 335. The Court there rejected the contention that all receipts—"everything that comes in"—are income within the proper definition of the term gross income. Thus in *Doyle* v. *Mitchell Brothers Co.,* 247 U. S. 179, the Court stated (p. 185):

> In order to determine whether there has been gain or loss, and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration.

And in *Snyder* v. *Commissioner,* 295 U. S. 134, the Court observed (p. 141, fn. 4):

> Proceeds from sales in the regular course of business constitute gross income of the business only to the extent that they exceed the cost of the goods sold. See *Spring City Foundry Co.* v. *Commissioner,* 292 U. S. 182, 185. * * *

We may safely conclude that ordinarily a taxpayer's gross income consists of his gross receipts less those receipts which constitute a return of the capital investment or the capital expended directly in production of income-producing goods. See Holmes, Federal Income Tax (Sixth ed.) 501.

The Treasury Regulations have accepted this concept. Treasury Regulations 111, Section 29.22(a)-5. Gross income is there defined, in the case of a manufacturing, merchandising, or mining business, as the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. This concept was applied by the Tax Court below with regard to the Lindseys. It accords with settled and unchallenged Bureau policy. See Mim. 2915, I-1 Cum. Bull. 233 (1922); I. T. 1241, I-1 Cum. Bull. 34 (1922). It may be noted that Mim. 2915 also states, in addition to accepting the concept of gross receipts less cost of goods sold, as follows:

> A lawyer, who is married and living with his wife, has gross receipts in the form of fees amounting to $6,000, and his necessary business expenses amount to $4,200, leaving a net income of only $1,800. A return would be required in this case [under Section 223(a) of the Revenue Act of

1921], as the taxpayer's gross income as well as gross receipts is $6,000.

Likewise, this concept of computing gross income accords with that upheld by the court in *Woodside Acres v. Commissioner,* 134 F. 2d 793 (C. A. 2d), relied on with such emphasis by taxpayers (Br. 10-12). The court there upheld the Commissioner's argument that accountants recognize direct costs in milk production which may be separated from the indirect or overhead expenses of farm operations. The direct costs, we argued therein, are (1) feed and (2) labor, in contrast to buildings, equipment, repairs, depreciation, bedding, supplies, delivery expenses, etc., which are indirect costs, citing Larsen, Milk Production Cost Accounts, pp. 2-3, 24-26, 38-45. The court held that feed and labor costs in the milk business should be deducted from gross receipts to ascertain gross income, in effect calling feed and labor in that business part of the cost of goods sold.

(1) On their returns for the taxable years involved (Ex. A-3, A-4, A-5, A-6), the Lindseys deducted from the gross receipts of the Commodore Cafe sole proprietorship not only the cost of goods sold but also other business expenses, i.e., operating expenses. We submit that under the foregoing authorities, the resulting figure is not gross income from the business but net income therefrom. The Commissioner disallowed, and in this was properly upheld by the Tax Court below, the deduction of anything but the cost of the goods sold. What is called on the tax return form gross profit is the equivalent of gross income, as the authorities indicate; for Schedule C of Form 1040, as used in 1944 and

1945 (See Ex. A-1, A-2, A-3, A-4, A-5, A-6), calls for the deduction of the cost of goods sold from gross receipts in order to determine gross profit. From gross profit, the Lindseys were entitled to deduct overhead expenses in order to ascertain their net income from the business. They conceded below that if the proper method of computation envisioned the subtraction of cost of goods sold from gross receipts, they were not entitled to the relief of Section 107(d). As we have demonstrated, that is the proper computation method. We feel constrained to emphasize that the accounting practice followed by the Lindseys to ascertain gross profit was proper accounting practice. Properly, to determine profit and loss in restaurant businesses, cost of food sales is first subtracted from gross receipts; the balance is closed out to an operation expenses account, which collects on its debt side all the indirect costs, or costs of operation, such as wages, cleaning, music, light and heat, laundry, silver, chinaware, etc. The balance of this account determines net profit or loss. III Kester, Accounting Theory and Practice (1921 ed.), p. 513.

Taxpayers' argument boils down to two propositions: the first, that gross income is not an immutable term; the second, that for purposes of Section 107(d) an individual taxpayer's gross income constitutes the sum of income items appearing on page one of the individual income tax return, Form 1040, as used in 1944 and 1945 (See Ex. A-1, A-2, A-3, A-4, A-5, A-6).

As taxpayers point out in their brief (pp. 19-20), page one of the return includes as income a taxpayer's total wages, salaries, etc.; the total amount of interest

and dividends; and any other income, the details of which are to be given in schedules within the return. These schedules, A through E, provide for the computation of net income from various sources, including rents and royalties and business or profession. Taxpayers also point out that the standard Form 1040 describes the sum of these items on page one as "your income."

But the sum of the items of income on page one of the return is neither gross income nor net income. On page four of Form 1040 as used in 1944 and on page three of that form as used in 1945, the sum of the income items on page one is denominated "This is your Adjusted Gross Income." To describe adjusted gross income as net income or gross income obviously is erroneous.

The terminology describing the income items on page one as adjusted gross income is consistent with and demanded by acts of Congress. By Section 8 of the Individual Income Tax Act of 1944, c. 210, 58 Stat. 231, Congress introduced the concept of adjusted gross income. By express terms of Section 2 of that Act amendments made therein applied for taxable years beginning after December 31, 1943, therefore covering the taxable years involved herein. Section 8 of the Act by its terms defines adjusted gross income for purposes of Chapter 1 of the Internal Revenue Code. It also introduces a new concept—adjusted gross income—into the revenue laws. H. Rep. No. 1365, 78th Cong., 2d Sess. p. 24 (1944 Cum. Bull. 821, 838). Taxpayers note that the concept of adjusted gross income was not in the Internal Revenue Code when Section 107(d) was en-

acted (Br. 22.) But the Individual Income Tax Act of 1944 made some changes and, significantly, did not make others. The concept of adjusted gross income was introduced into Section 23(o) and (x) of the Code by Section 8(b) and (c), permitting, respectively, deduction of charitable contributions limited to a percentage of adjusted gross income and permitted medical expense deduction of amounts in excess of 5% of adjusted gross income. The concept of adjusted gross income was also introduced into Section 23(aa) of the Code by Section 9 of the Act. The Act amended, by Section 8(d), Section 117(d)(2) of the Code in such a way as to suggest that adjusted gross income was considered by Congress more nearly in the nature of net than gross income, for it provided therein that for certain purposes net income as used in that section should be read as adjusted gross income. This is consistent with Congressional treatment of Section 23(o) and (x) of the Code under the Act, for previously the percentages involved in those sections had been percentages of net income, and became percentages of adjusted gross income under the Act, as we have noted, *supra*. At the same time, Congress amended Sections 60 and 251 of the Code, by Sections 13(a) and 10(h), both of which call for the ascertainment of percentages of gross income, but did not introduce into those sections any new concept of gross income, nor define gross income as used in those sections as adjusted gross income. Clearly it would not have, for Section 22(n) as enacted in 1944 describes adjusted gross income as gross income less certain deductions provided in Section 23 of the Code.

That gross income is then implicitly defined by the

Code as the sum of adjusted gross income plus certain of the items which may be deducted under Section 23 follows *a fortiori*. It would be impossible for adjusted gross income to constitute gross income for any purpose. That this is logical is clear from the items of income that are included in adjusted gross income. For example, in the case of income from a business, the cost of goods sold is first deducted to arrive at gross profit or gross income. Then are deducted ordinary and necessary business expenses and other deductions allowed by Section 23. The result is net profit, which is carried to page one of the individual tax return as an element in adjusted gross income. It is not yet individual net income, for there are still to be deducted the individual's personal deductions and his exemptions. The fact that the items of income on page one are called adjusted gross income indicates that an adjustment not appearing upon that page has been made, which is in fact the case with respect to the schedules—A through E—contained within the body of the return.

In view of the foregoing, we believe the Tax Court was eminently correct in its determination that in computing the Lindseys' gross income for purposes of Section 107(d), their community shares of gross income from the sole proprietorship should have been included, rather than their community shares of the net profits of that business.

(2) The Tax Court held, erroneously we believe, that since the Langers were joint venturers in the operation of the Figueroa and Clifton Hotels, there need be included in their gross income only their distributive share of the joint venture net income. The

Commissioner conceded below that if partnership returns for the Langers had been filed he would not question the Langers' inclusion only of their share of the net profits from such ventures in their individual gross incomes. He maintained only that failure of file partnership returns defeated their attempt to contend that the net income from the two ventures was in fact income from joint ventures within the meaning of the Internal Revenue Code. We do not here reiterate that contention.

But we do contend that the Commissioner was wrong below in conceding that if partnership returns had been filed, there would be no questioning of the Langers' inclusion only of the net distributive share of venture profits in gross income. If the concession is of bad law, it is certainly not binding upon this Court. Moreover, despite what may be said with respect to our taking an inconsistent position herein, the position we take is consistent, just as the concession below was inconsistent, with prior administrative policy of the Bureau of Internal Revenue. I. T. 3981, 1942-2 Cum. Bull. 78, holds that in the case of a member of a partnership, gross income for the purposes of Section 251 of the Internal Revenue Code, relating to income from sources within the possessions of the United States, includes the partner's proportionate share of the partnership gross income, not his share of the ordinary net income. Such a position is logically consistent with what we argue herein with respect to the Lindseys. It is our position with respect to them that although only the net income from their business is reported as adjusted gross income on the face of their returns, their

actual gross income for purposes of Section 107(d) includes the gross income of their business. Similarly, with respect to the Langers, only the net distributive share of their joint venture income appears on the face of their returns as adjusted gross income. But to determine their total gross income, we must look to the gross income of their business, whether that business be carried on as a sole proprietorship or as a joint venture. The joint venture is not a tax-paying entity for tax purposes, although properly the Langers as joint venturers should file an information return. An individual's gross income from corporate dividends, e.g., is an entirely different matter from his gross income from a partnership.

It makes no difference that an individual is only required to report on his individual tax return the distributive share of the partnership business net profits; the individual return also calls only for a reporting of the net profit or loss from a business or profession. Schedule C of the 1944 and 1945 returns whereunder the Lindseys showed how the net profit of their sole proprietorship was ascertained is in the nature of an information return. Although contained within Form 1040, it is similar to a partnership information return, nevertheless. Logically, there is no difference between the approach that should be taken toward the income to the individual engaged in the two forms of business, the partnership and the sole proprietorship. And at any rate by definition the distributive share of partnership net income constitutes a portion only of individual net income. Internal Revenue Code, Section 182. The partnership net income is computed similarly

as individual net income, with certain specific exemptions. Section 183. Under the circumstances, we believe the Tax Court erred in making a distinction with respect to the Langers because they were joint venturers, and, as such, recipients of income by way of their net distributive shares of their joint ventures.

Since the Langers should have included in their gross income their proportionate share of the gross income of their joint venture income, it becomes germane to ascertain what the gross income of the ventures was. On their returns for 1944 (Ex. A-1, A-2), the Langers deducted as expenses from gross rentals received on account of the Clifton Hotel the following: taxes, interest on mortgage, depreciation, to the total of $7,813.70. One-half these expenses was allocable to the Langers, one-fourth to each, or $1,953.42 to each. Since these deductions are to be deducted by Section 22(n) from gross income, by reference to Section 23, to ascertain adjusted gross income, the expenses should be included in the Langers' gross income for 1044, for with regard to their rental income gross rents were synonymous with gross income. This, however, was not done on their returns. Instead, taxpayers erroneously argue here that only the net income from the rentals should be included in gross income.

With regard to the Figueroa Hotel, on their returns for 1944 the Langers deducted all expenses of operation. These expenses include both labor costs and overhead. Overhead costs properly include the usual items of rent or occupation cost, insurance, taxes, light, heat, power, depreciation, repairs, supplies, and any other indirect expenses incident to the operation of a hotel.

III Kester, *supra,* 514. It is doubtful, although we do not concede the point, that the Langers' gross receipts from the Figueroa Hotel should be included in gross income. Certain of the expenses of operation are more nearly direct than indirect charges, particularly wages. But many of the charges the Langers set out in their enumeration of operating expenses are items which are deductible from gross income, rather than excludible in arriving at gross income. Into the hopper of overhead expenses, i.e., indirect costs, logically fall such items as advertising expenses, printing and stationery, front office expense, music and entertainment, taxes, repairs, light, heat, and power, for example. The sum of just these expenses, excluding sums which should be allocated out of the accounts labelled "Furniture replacement and repairs" and "carpet replacement and repairs", totals $18,412.61, plus $3,906.84 on account of their rental income from the Clifton Hotel. This figure does not even take into account rental and labor expenses allocable to overhead, rather than to the direct costs of goods sold, i.e., hotel service. It is clear that there is an ample amount which should have been included in the Langers' gross income to more than increase the gross income of each well over the sum of which their back pay must be 15%. If the gross income of each of the Langers exceeded $33,333.33—for $5,000, the share of each in back pay for 1944, is 15% of that sum, then the benefits of Section 107(d) are not available to them. The Tax Court found that Langer's gross income was $30,729.45, his wife's $31,854.43. Clearly, it would take but a slight portion of the sums properly includible in their gross income from the

Figueroa and Clifton Hotels to reach the figure of $33,-333.33. And the record amply shows sufficient items for such a purpose.

## CONCLUSION

In view of the foregoing, we believe it has been demonstrated that the Tax Court did not err with respect to the Lindseys, but did err with respect to the Langers.

Respectfully submitted,

THERON LAMAR CAUDLE,
*Assistant Attorney General.*

ELLIS N. SLACK,
A. F. PRESCOTT,
EDWARD J. P. ZIMMERMAN,
*Special Assistants to the Attorney General.*

OCTOBER, 1951.

**APPENDIX**

Internal Revenue Code:

Sec. 107 [As added by Sec. 220(a) of the Revenue Act of 1939, c. 247, 53 Stat. 862 and amended by Sec. 139(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798, and Sec. 119(b) of the Revenue Act of 1943, c. 63, 58 Stat. 21]. Compensation for Services Rendered for a Period of Thirty-six Months or More and Back Pay.

(d) [As added by Sec. 119(a) of the Revenue Act of 1943, supra] Back Pay.—

(1) *In General.*—If the amount of the back pay received or accrued by an individual during the taxable year exceeds 15 per centum of the gross income of the individual for such year, the part of the tax attributable to the inclusion of such back pay in gross income for the taxable year shall not be greater than the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for the taxable years to which such portions are respectively attributable, as determined under regulations prescribed by the Commissioner with the approval of the Secretary.

(2) *Definition of Back Pay.*—For the purposes of this subsection, 'back pay'' means (A) remuneration, including wages, salaries, retirement pay, and other similar compensation, which is received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year except for the intervention of one of the following events: (i) bankruptcy or receivership of the employer; (ii) dispute as to the liability of the employer to pay such remuneration,

which is determined after the commencement of court proceedings; (iii) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (iv) any other event determined to be similar in nature under regulations prescribed by the Commissioner with the approval of the Secretary; and (B) wages or salaries which are received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which constitute retroactive wage or salary increases ordered, recommended, or approved by any Federal or State agency, and made retroactive to any period prior to the taxable year; and (C) payments which are received or accrued during the taxable year as the result of an alleged violation by an employer of any State or Federal law relating to labor standards or practices, and which are determined under regulations prescribed by the Commissioner with the approval of the Secretary to be attributable to a prior taxable year. Amounts not includible in gross income under this chapter shall not constitute "back pay."

(26 U.S.C. 1946 ed., Sec. 107.)

Treasury Regulations 111, promulgated under the Internal Revenue Code:

Sec. 29.107-3 [As added by T. D. 5389, 1944 Cum. Bull. 196]. Back Pay Attributable to Prior Taxable Years.—Section 107(d)(2) defines "back pay" and section 107(d)(1) limits the amount of tax resulting from the inclusion of such back pay in gross income for the year in which it is received

or accrued. Back pay includes compensation for wages, salaries, pensions, and retirement pay received or accrued during the taxable year by an employee for services performed prior to the taxable year for his employer and which would have been paid prior to the taxable year but for the intervention of any one of the following events: (1) bankruptcy or receivership of the employer; (2) dispute as to the liability of the employer to pay such remuneration, which is determined after the commencement of court proceedings; (3) if the employer is the United States, a State, a Territory, or any political subdivision thereof, or the District of Columbia, or any agency or instrumentality of any of the foregoing, lack of funds appropriated to pay such remuneration; or (4) any other event determined to be similar in nature under these regulations. As to what constitutes bankruptcy and receivership proceedings see Section 29.274-1.

* * *

An individual must compute his net income for any taxable year to which back pay is attributable, even thought he was not required to make a return for such year. Thus, all amounts properly includible as gross income for any taxable year to which back pay is attributable must be included in the computation.

* * *

The first step in determining whether section 107(d) is applicable is the determination of the percentage which the back pay is of the gross income of the taxpayer for the current taxable year. It must exceed 15 per centum of such gross income. The amount of the tax attributable to such back pay is the difference between the tax for the taxable year computed with the inclusion of such back pay

in gross income and the tax for such taxable year computed without including such back pay in such gross income.

The amount of the tax attributable to such back pay in each taxable year is the difference between the tax for such taxable year computed with the inclusion in gross income of the portion of such back pay attributable to such taxable year and the tax for such taxable year computed without including any part of such back pay in gross income.

The tax for the current taxable year is (1) the tax computed with the inclusion in gross income of the entire back pay received or accrued in the taxable year, or (2) the tax computed without including any such back pay in gross income for the current taxable year, plus the aggregate of the increases in the taxes which would have resulted from the inclusion of the respective portions of such back pay in gross income for each taxable year to which each such portion is respectively attributable, whichever is the smaller.

This may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1944 and 1941 the alternative tax provided in Supplement T:

*Example.* In 1944 a single person with no dependents who who makes his income tax returns on the calendar year basis receives $2,900, which amount constitutes his adjusted gross income. Of this amount, $500 constitutes back pay. His tax for the calendar year 1944 on $2,900 would be $490. On $2,400 ($2,900 minus $500) the tax would be $384. That part of the tax for 1944 attributable to back pay is therefore $106 ($490 minus $384).

Of the back pay, $300 is attributable to the year 1941. During such year he had received $2,000. For such year the amount of the tax on $2,000 is $104. The amount of tax which he would have paid for such year had he included in gross income the portion of back pay attributable to such year would be $130. The increase in the tax for such year would be $26 ($130 minus $104).

The remainder of the back pay, $200, is attributable to the calendar year 1940. During such year his net income was $1,800. For such year the amount of tax, including the defense tax, on $1,800 is $36.08 and the amount of tax, including the defense tax, which he would have paid for such year had he included in gross income the portion of back pay attributable to such year would be $44. The increase in the tax for such year would be $7.92 ($44 minus $36.08). The aggregate of increases in the taxes for the calendar years 1941 and 1940 would be $33.92. The tax for the calendar year 1944 is the smaller of $384 plus (1) $106 or (2) $33.92. Since $33.92 is smaller than $106, the tax for the calendar year 1944 is $417.92 ($384 plus $22.92).

Section 6(d)(3) of the Current Tax Payment Act of 1943, as amended by section 506(b) of the Revenue Act of 1943, provides that section 107 of the Internal Revenue Code shall be applied without regard to subsections (a) and (b) of section 6 of the Current Tax Payment Act of 1943. For example, a taxpayer who had received or accrued compensation including back pay in 1943 determines his income tax, including the victory tax, for such year in the manner provided in section 107 of the Internal Revenue Code before the application of section 6. In the process of determining

such tax, portions of such compensation are attributable to prior years and the limitation upon the increase in the tax for 1943 attributable to such compensation is determined by reference to the tax for the respective years computed upon the portion of such compensation allocable to such years. While all of such compensation is included in gross income for 1942 or 1943, as the case may be, such compensation is attributable to prior years without regard to section 6 of the Current Tax Payment Act of 1943. This may be illustrated by the following example in which the taxpayer makes his returns on the cash receipts and disbursements basis, and in which it is assumed that he is entitled to use and uses for the taxable years 1943, 1942, and 1941 the alternative tax provided in Supplement T.

*Example.* In 1943 a single person (not the head of a family) who makes his income tax return on a calendar year basis receives $2,200. Of this amount, $600 constitutes back pay. Including the victory tax, his tax liability for 1943 on $2,200 would be $342.10. On $1,600 ($2,200 minus $600) the tax liability would be $216.60. That part of the tax liability for the calendar year 1943 attributable to back pay is therefore $125.50 ($342.10 minus $216.60). Of the back pay, $400 is attributable to the calendar year 1942. During such year he had received $1,000. For the calendar year 1942 the amount of tax liability on $1,000 is $76. The amount of tax liability for such year had he included in gross income the portion of back pay attributable to the calendar year 1942 would be $145. The increase in the tax liability for such year would be $69 ($145 minus $76).

The remainder of the back pay, $200, is attributable to the calendar year 1941. During such year he had received $1,000. For such year the amount of tax on $1,000 is $18, and the amount of tax which he would have paid for such year had he included in gross income the portion of back pay attributable to the year 1941 would be $35. The increase in the tax for such year would be $17 ($35 minus $18). The aggregate of the increases in the taxes for the calendar years 1942 and 1941 would be $86. The tax liability for the calendar year 1943 is the smaller of $216.60 plus (1) $125.50 or (2) $86. Since $86 is smaller than $125.50, the tax liability for the calendar year 1943, prior to the application of section 6 of the Current Tax Payment Act of 1943, is $302.60. For the application of section 6 of the Current Tax Payment Act of 1943, see the regulations thereunder, set forth in Treasury Decision 5300, approved October 1, 1943 (C. B. 1943, 47), and amendments thereto.

☆ U.S. GOVERNMENT PRINTING OFFICE 1951—969888/P.O. 277